NO. 15710

IN THE

UNITED STATES

COURT OF APPEALS

For the Ninth Circuit

JACK SHOWELL AND DOROTHY SHOWELL,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF FOR PETITIONERS
On Petition for Review of the Decisions of the Tax Court of the United States

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W. LEE MCLANE, JR.
NOLA MCLANE
806 Security Building
Phoenix, Arizona
Counsel for Petitioners

MCLANE & MCLANE
806 Security Building
Phoenix, Arizona
Of Counsel

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ARGUMENT

I

Respondent has not submitted a reply to any of the six or more arguments, contained in Point I of petitioners' opening brief, in support of their conclusion that the Tax Court memorandum

opinion of January 31, 1957, did not comply with the majority opinion in *Showell v. Commissioner,* 9 Cir., 1956, 238 F. 2d 148. Instead, and as will be shown herein, respondent's brief from pages 6 through 10 answers arguments which were not made by petitioners, consumes pages 6 and 7 summarizing this Court's majority opinion, absorbs most of pages 8 through 10 restating the Tax Court's opinion, and offers conclusions which are based solely on the foregoing. Petitioners ask the Court, in the interests of appraising both the relevance and the substance of the merits of respondent's answers to note how this avoidance has been accomplished.

In Point I of petitioners' brief, it was pointed out that the following language established the reason why this Court remanded the case and what the Tax Court was ordered to do:

> "The *only* thing that justifies the conclusions reached by the Commissioner or the Tax Court is disbelief or dissatisfaction with *the testimony.* Yet *the findings* are not sharp enough to tell us this. . . .
>
> "The remand will therefore be on the ground that *the findings* were not sufficiently definitive" (Emphasis supplied)

This is clear language. It says to the Tax Court: (1) If you are going to decide the case the way you have, the only way you can do it is to make *findings* that you disbelieved or were dissatisfied with *the testimony;* and (2) the case is now remanded to you for *findings* which are sufficiently definitive. It is this mandate which petitioners contend has not been complied with for the six reasons set forth in Point I of their opening brief.

However, respondent has avoided answering by selecting certain sentences of this Court's majority opinion, and then concluding that the objections therein voiced have been overcome by the Tax Court's *decisions.* However, respondent never deals with the primary issue of whether the Tax Court has made findings of fact that it disbelieved or was dissatisfied with *the testimony* and whether *the findings* were sufficiently definitive. That is why the first two paragraphs of pages 6 and 7 of respondent's brief are required. They carefully select the sentences from the majority

opinion which are later to be "answered". And it is for this reason that petitioners dispute the conclusion found in respondent's brief immediately after page 6 and most of page 7 that:

> "It is in this posture, then, that the instant petitions for review must be considered in order to determine whether the Tax Court decisions are proper in view of the prior remand." (Respondent's brief, 7).

No doubt such "posture" aids respondent's cause, but it is not responsive to the issue presented to the Court.

Immediately after the above quotation, and on page 7 of his brief, respondent initiates the "answer" portion of his argument by saying that "the Tax Court has *properly* exercised its prerogatives as the trier of fact" and "its decisions are correct in view of the prior opinions of this Court". This is an unsupported conclusion and statement of preference, and, as such, should be ignored.

Next, at pages 7 and 8, respondent states that the Tax Court has *now* made it plain that the issue is a factual one. But what is the relevance of this statement? How does it serve as an answer to petitioners' reasons why the Tax Court's findings do not comply with this Court's mandate. Also, it is not correct for respondent to leave the inference, by the use of the word "now", that this statement of the Tax Court is something new. After all, in its first regular opinion, the Tax Court stated: "As we see it, the question resolves itself into one of fact, . . ." *Showell v. Commissioner,* 1954, 23 TC 495.

Following the above observation, respondent next argues, at page 8, that the Tax Court's "memorandum findings of fact *and* opinion no longer contain the inconsistency which existed in the prior findings of fact and opinion." This "answer" is offered in reply to respondent's conclusion in the last sentence of the first paragraph on page 6 that:

> "As a result, then, of this *inconsistency* and of the reportorial nature of the Tax Court's finding this Court remanded to the Tax Court." (Emphasis supplied)

The above quoted sentence, which was a prerequisite to an "answer" that the inconsistency no longer exists, may reflect the unrest felt by this Court after reading the Tax Court's first findings of fact at 23 TC 495. However, this Court did not send the case back to the Tax Court simply for the purpose of making the facts consistent with the decision. Is it an answer to petitioners' argument that the Tax Court did not find as fact that the testimony of the witnesses was disbelieved or was unsatisfactory for respondent to say that the findings of fact and opinion no longer contain the inconsistency which existed in the prior findings of fact and opinion? Petitioners were under the impression that this Court was disturbed about the apparent inconsistency between the findings of fact and the decision, and therefore ordered findings of fact which were sufficiently definitive. Has this failure to find facts sufficiently definitive been remedied when respondent points out that the findings of fact *and* opinion are no longer inconsistent? This Court did not order that the Tax Court's opinion be reworded so that it would be consistent with the decisions. It ordered sufficiently definitive findings among which would be the finding that the Tax Court disbelieved or was dissatisfied with the testimony should the Tax Court decide the case again as it did before. This was not done, but respondent answers by saying it does not matter because the findings of fact *and* opinion are now no longer inconsistent. This is neither an answer nor relevant.

The next contention by respondent is that the Tax Court has now stated it was unconvinced. Yes, but where is this statement made, and what is the Tax Court unconvinced about? The statement is not a finding of fact at all. It is not a *finding* of fact that the Tax Court *disbelieved* or was dissatisfied with *the testimony.* Nor did respondent quote the qualifying words of the opinion which were: "On this record we are unconvinced." Respondent has answered none of petitioners' contentions found at page 12 of their opening brief.

Next, the respondent explains that this time the Tax Court "has carefully refrained" from making any findings of fact concerning

Exhibit 3, and has only found that the books and records were inadequate. If so, what is the deficiency itself based on? The only basis of the statutory notice of deficiency has thus been eliminated once the presumption of prima facie correctness disappeared. Since the examining agent testified that the sole basis of the deficiency was the figures appearing in the Gain column of Exhibit 3 less four items appearing in the Loss column, what are the facts which remain as the basis of the additional income? It is all right to enunciate the legal truism that deductions must be proved, but what happened to the source of the deficiency itself? Respondent is now asking this Court to sustain a deficiency having no basis in the finding of fact and which clearly only rests upon a legal presumption of correctness. In this Court's majority opinion, Judge Chambers gave the Tax Court the benefit of the doubt by saying that perhaps there was an implied finding that the testimony was unsatisfactory. Now the respondent is asking the Court to sustain the Tax Court although it has "carefully refrained" from making *any* findings of fact concerning the exhibit which served as the sole basis of the Commissioner's deficiency.

Respondent's next statement, at pages 8 and 9, that the Tax Court found that petitioner did not maintain regular, adequate and permanent books and records is simply a restatement of one of the findings of fact, and cannot rebut or answer arguments to the effect that the Tax Court's findings were not sufficiently definitive.

Next, respondent "answers" by stating at page 9, that the Tax Court has "carefully considered" this Court's opinion and has applied the legal principles contained therein. Again this is simply a statement of preference and unsupported conclusion. Furthermore, it is not any answer to petitioners' specific grounds for asserting the Tax Court did not comply with this Court's mandate.

Immediately thereafter, at page 9, respondent "answers" by saying that: it is the taxpayer's burden to prove error in the Commissioner's determination, only Exhibit 3 was offered to support that burden, and therefore the Tax Court could "on this record" remain unconvinced. Not only does this reason fail again to answer the

charge that the *findings* are not sufficiently definitive and do not find that *the testimony* was disbelieved, but it is not a correct statement of the law nor a correct paraphrase of the Tax Court's opinion.

To begin with, the Tax Court arrived at its burden of proof by the following procedure. First, it said: "As indicated by the opinion of the Court of Appeals herein, the burden is on the taxpayer to sustain by competent evidence his claimed deductions." Then the Tax Court said:

> "In other words, it is the petitioner' burden to prove error in respondent's determination, . . ."

But is this statement by the Tax Court correct?

The burden of proof is different from the legal presumption of correctness that attaches to the Commissioner's determination. Thus, when contrary evidence is placed into the record the presumption of prima facie correctness is gone completely and the case is wide open. *J. M. Perry & Co. v. Commissioner,* 9 Cir., 1941, 120 F. 2d 123; 9 Mertens, Law of Federal Income Taxation, §50.71 (1943). Here there was *nothing but contrary evidence* in the form of testimony from two witnesses and Exhibit 3. Also, the Tax Court itself disregarded the Commissioner's determination. Thus, it cannot be disputed that the legal presumption of prima facie correctness attaching to the Commissioner's determination evaporated, and, consequently, could not be treated as evidence. *Hemphill School, Inc. v. Commissioner,* 9 Cir., 1943, 137 F. 2d 961. Therefore, the only question left is what is the taxpayer's burden of proof and has it been carried?

The Tax Court says the taxpayer must prove the Commissioner's determination is erroneous. Although petitioners accomplished this as evidenced by the Tax Court's finding that the deficiency was incorrect, this is not a correct statement at all as to what constitutes the burden of proof in tax cases. In order to carry his burden of proof, a taxpayer must prove his facts before the court by a "preponderance of the evidence" (*Schilling Grain Corp.,* 1927, 8

B.T.A. 1048) such as would reasonably support a verdict for a plaintiff in an ordinary action for the recovery of money (*Burnet v. Niagara Falls Brewing Co.,* 1931, 282 U.S. 648, 51 S. Ct. 262, 75 L. Ed. 594). The burden of proof means that where the evidence *is in even balance* and the tribunal cannot say which would win, the party upon whom rests the burden of proof will lose. CCH Procedure and Practice Before the Tax Court of The United States, §299 at page 135 (17th ed. 1957). In this case there was no evidence at all in support of the Commissioner once the presumption of prima facie correctness disappeared. Consequently, the preponderance of evidence must have been in favor of petitioners. And how could the burden of proof rule be invoked against petitioners if it simply means they lose *if* the evidence *is in even balance.* There could be no even balance in this case because the Commissioner introduced no evidence of any kind.

Consequently, what is the Tax Court saying when it says the taxpayer must prove the Commissioner's determination is erroneous? If it is implying that something more than a preponderance of the evidence is required, it is wrong. On the other hand, if it is saying that petitioners did not have a preponderance of the evidence, it is ignoring the entire record. Surely it cannot be saying all of petitioners' evidence must be disregarded as not competent in view of the fact that: (1) All of it was admitted into evidence without objection by respondent, (2) Exhibit 3 served as the sole basis of the Commissioner's determination, (3) The testimony was uncontradicted, and (4) All of the evidence, testimony and documents, served as the basis of its first lengthy findings of fact at 23 TC 495. If the rejection is on the basis that uncontradicted testimony and a document upon which the Commissioner based his deficiency does not constitute competent evidence, then what the Tax Court is actually holding is that it was impossible for petitioners to carry their burden of proof without the daily individual bet slips. Since that is precisely what the trial judge's dissenting opinion in 23 TC 495 held, it is clear that we are back either to the erroneous rule that a taxpayer must conclusively prove the losses to carry his

burden of proof, or the equally erroneous rule that it was *impossible* to carry his burden of proof without the daily bet slips. In view of the fact that even respondent refused to support the trial judge's theory and this Court's majority opinion denied the conclusive proof requirement, what is left when, upon the basis of the foregoing statement, the Tax Court stated that on this record it was unconvinced. It was saying, in different words, you did not give us conclusive proof or it was impossible for you to carry the burden of proof without the daily bet slips.

One other point which petitioners emphasize is that the Tax Court did not say the *only* evidence offered by petitioners was Exhibit 3. It said:

> "To sustain that burden the petitioner relies *almost* exclusively upon his own testimony and that of his accountant." (Emphasis supplied)

Even the Tax Court acknowledged the testimony of petitioner Showell and Houston L. Walsh which respondent constantly avoids. Also, it is important to point out that the petitioners offered voluminous "net worth and disbursements evidence" which the Tax Court refused to admit saying it was not relevant or material. Thus, when petitioners relied only on the testimony of petitioner Showell and Mr. Walsh, and Exhibit 3, it was not by choice, but because the Tax Court refused to admit net worth and disbursements evidence as not relevant or material even though it found as fact that petitioners' books and records were inadequate.

At page 9, respondent further summarizes the Tax Court's opinion pointing out it did believe that Showell suffered some losses. Where is the competent evidence to support this belief? Also, the corollary thereto, that the Tax Court finds as fact that it disbelieved the testimony, will not be found.

Next, at pages 9 and 10, respondent says that this Court indicated "that if there had been a Tax Court finding that the testimony was not satisfactory," the decision could stand. Then he points out that the Tax Court in its findings *and* opinion has

stated "the evidence is unsatisfying". This is somewhat misleading. The statement is found in the opinion and not in the findings, and it refers to the "evidence" whereas this Court's majority opinion stated that the only thing which justifies the conclusions is disbelief or dissatisfaction with *the testimony.* That is why petitioners contend the Tax Court is simply restating its previously announced rule that conclusive proof is required. Furthermore, the Tax Court did not say that it was unconvinced by the record that Exhibit 3 was an accurate statement of petitioner's bookmaking business. Instead, it said, in its opinion, and not as a finding of fact, that:

> "On this record we are unconvinced that the petitioner suffered wagering losses to the extent claimed."

Respondent slides over the phrase "on this record" which petitioners have discussed in support of one of their contentions at page 14 of their opening brief.

Finally, respondent answers one of the sentences from this Court's majority opinion which said the Tax Court should make it clear that this case does not establish an overriding precedent that a taxpayer without certain records cannot overcome the burden of proof. The answer, according to respondent, is the Tax Court's statement that this is a fact case. But as pointed out earlier, this statement was made in the first regular opinion at 23 TC 495, and if such a statement was sufficient answer Judge Chambers would certainly not have told the Tax Court to make it clear. Furthermore, all cases are fact cases when it comes to determining income. What does such a statement add to the first opinion?

It is upon the basis of the foregoing arguments and the complete failure to respond to petitioners' contentions that respondent reaches the conclusion that the Tax Court's decision is in complete accord with this Court's mandate. For the reasons set forth in Point I of petitioners' opening brief and herein, and in view of respondent's failure to answer, it is submitted that petitioners should be sustained as to this assignment of error.

II

Respondent's second point is a three and one-half page reply to the contentions supporting petitioners' Points II through VI contained in pages 16 through 39 of the opening brief.

Although a few arguments are made, respondent's basic answer is the notion that the petitioners should not be permitted to raise the *same* questions raised in the first appeal since this Court's decisions have become the law. Before turning to the issue of whether the questions raised in these latter five points of petitions' brief are the same, it is necessary to determine whether this Court's power to review is limited after it sends a case back to the court below for findings of fact which are sufficiently definitive.

The only case cited by respondent is *Todd v. Commissioner,* 9 Cir., 1948, 165 F. 2d 781, while petitioners cited *McGah v. Commissioner,* 9 Cir., 1954, 210 F. 2d 769 in support of the proposition that the present appeal is in the nature of a rehearing. In the 1948 *Todd* case, *supra,* this Court sustained the validity of a formula adopted by the Tax Court to determine the respective contributions of the taxpayers' separate and community property, but sent the case back to the Tax Court because of the lack of certain findings. On the first appeal, the taxpayer disputed the validity of the formula used by the Commissioner in ascertaining the respective contributions of the taxpayers' separate and community property and their personal activities to their partnership income, which formula had been sustained by the Tax Court. This Court held that the formula adopted was a rational one and remanded the case to the Tax Court for further findings respecting attributions to capital and to the taxpayers' management of the business, and a new decision. On the second appeal, the taxpayers again attacked the formula without more. Thereafter, on the second appeal, this Court held that the validity of the formula had already been determined. On the other hand, in the *McGah* case, *supra,* Judge Orr remanded with instructions to the Tax Court to make further findings and enter such decision as it deemed proper. Upon remand, the Tax Court took no additional evidence. This Court, on

a second appeal, said at page 770: "Our mandate in this case was, in essence, a directive for a rehearing. We directed the Tax Court to make findings on the issue of whether the 14 houses were held for sale for a time prior to sale, and if so, when and how long they were so held, and to enter such decision as it deemed proper. The Tax Court had the power, if it deemed necessary, to take additional evidence and make such determination thereon as the facts warranted. . . . The fact that the Tax Court felt itself able to comply with the directive on the record then before it does not change the character of the proceeding. The petition for review was timely." Following this statement the Ninth Circuit proceeded to reverse the decision of the Tax Court holding that it was free to draw its own inference from uncontroverted evidence and reverse the Tax Court's findings and conclusions if necessary.

Here the Court sent the case back to the Tax Court for findings which were sufficiently definitive. If so, how can it be said that assignments of error arising out of these *new* findings cannot be reviewed by this Court.

For instance, petitioners' Point II raises the contention that in view of the new finding of fact that petitioners' books and records were inadequate, the Tax Court erred in sustaining a determination of income which was not based upon a *method* as required by Section 41, Internal Revenue Code of 1939. How does this Court's majority opinion in *Showell v. Commissioner,* 9 Cir., 1956,238 F. 2d 148, decide that issue which arose out of this finding of fact which was not made in the Tax Court's regular opinion at 23 TC 495? Also how does this Court's majority opinion control Point III which raises the issue of whether such a finding of fact constitutes error in view of the fact there was no such finding in the Tax Court's first opinion. Third, petitioners contend in Point IV that the Tax Court's new finding of fact that petitioners realized additional income of $19,563.66 is clearly erroneous since it is not supported by the evidence. This assignment of error is based upon what the Tax Court did after the remand, and clearly is reviewable. Next, petitioners argued in Point V that the Tax Court's new

findings of fact and opinion reflect that the Tax Court misapplied the burden of proof rule in reaching its decisions after remand. This too is reviewable. And lastly, in Point VI, that the Tax Court erred in refusing evidence concerning petitioners' net worth and disbursements in view of its new finding that petitioners' book and records were inadequate. This, too, is certainly a question which the Court may review in the light of the Tax Court's findings after remand.

It is true that many of the arguments supporting these assignments of error are like those made in the first appeal, but they are now to be viewed in light of the Tax Court's new findings of fact which give rise to the assignments of error. For respondent to fail to answer Point II through VI and urge that the Court should not review these points is fairly close to an admission that there were no answers to be submitted. What respondent is saying is that if a petitioner wishes to protect his record for a subsequent petition for a writ of certiorari, he must so petition before this Court has enough facts upon which it can intelligently decide the case. However, the significant factor here is that the issues raised in this appeal, as set forth above, have not been decided by this Court for the reason that they arise out of the Tax Court's new findings of fact and memorandum opinion.

In Point II of their opening brief, petitioners submitted that the determination of income must be in accord with some method once the Commissioner has found the books and records inadequate, as required by Section 41, Internal Revenue Code of 1939. Respondent replies by saying that the Commissioner did not change the taxpayer's method of accounting. This is not responsive. Petitioners did not say that the Commissioner changed his method of accounting, but did say that no method was used to determine his income as required by Section 41. Also, is it reasonable to say that the Commissioner has not changed a taxpayer's method of accounting when he disregards one-half of the latter's records, and determines income without the use of any method?

Furtherfore, it makes no difference whether Section 41 refers to a method of accounting or simply a method of determining income. In either case, the Commissioner has failed to adopt a method. Nor is the failure to comply with Section 41 resolved by the truism that the Commissioner put the taxpayers to their proof. The only proof taxpayers are put to is the burden of proof in the Tax Court, and that burden has been carried in this case.

Furthermore, this whole matter of referring to this case as one involving specific disallowance of claimed deductions needs clarification. This case involves the issue of whether or not the Tax Court may find as fact that a taxpayer's books and records are not regular, adequate and permanent, when the sole basis of the Commissioner's notice of deficiency is the accuracy of certain columns contained in those same inadequate, impermanent and irregular books and records. Respondent has failed to reply to the substance of petitioners' contention that the Tax Court may not sustain a determination of income which is not based on any method of ascertaining income because Section 41 has been violated.

On page 11 of petitioners' opening brief it was stated that the Tax Court will not find as fact that it disbelieved or was dissatisfied with the testimony because the Tax Court does not wish to raise the issue as to how such a finding was made in view of the fact that the Tax Court Judge who spoke for the majority did not observe the demeanor of the witnesses. Respondent does not answer this suggestion, but quoted from this Court's opinion that: "The fact trier had the right to remain unconvinced." But this is not the problem. The fact trier, Judge Withey, stated clearly that insofar as he was concerned, it made no difference whether the witnesses were believed or not. This was due to his opinion that it was impossible for the taxpayers to carry their burden of proof without the daily bet slips. That is why he said "that if the record justifies the allowance of any losses in excess of those allowed by respondent it justifies the allowance of the full amount of losses contended for by petitioners." However, since it was his view that

petitioners coud not carry their burden of proof without the daily bet slips, petitioners should be entitled to nothing.

Next, respondent argues that the Tax Court could not have imposed a standard of conclusive proof since if it had done so there would have been no basis for the Tax Court's allowance of $3,000.00 in addition to the amount allowed by the Commissioner. Yet that is precisely what the Tax Court said in its first regular opinion when it said: "We cannot accept the evidence as conclusive proof of the full amount of the claimed losses."

Again, on page 12, respondent reiterates the statement that petitioners urge that Exhibit 3, standing alone, establishes the existence of losses. This is simply not a correct statement. Petitioners offered the testimony of petitioner Showell and Houston L. Walsh, as well as Exhibit 3, and offered to prove by net worth and disbursements evidence that the additional income asserted by the Commissioner could not have been realized. Furthermore, as this Court will remember, petitioners' counsel argued in the briefs filed in the first appeal herein that the real issue is whether or not the petitioners sustained the additional income asserted by the Commissioner of Internal Revenue, and that books and records are evidence of the facts but are not the facts themselves. It was there contended that the existence or absence of a book or record is not controlling since such a rule would elevate a document (evidence of a fact) to the status of fact itself. Seemingly, this Court's majority opinion in *Showell v. Commissioner,* supra, agreed with this conclusion when it stated that "the only thing that justifies the conclusion reached by the Commissioner or the Tax Court is disbelief or dissatisfaction with the testimony." The basic question before the Tax Court was not whether or not petitioners had maintained books and records sufficiently detailed to satisfy the Commissioner of Internal Revenue. The question there was whether or not petitioners sustained the alleged additional income asserted by the Commissioner. The answer to that question did not depend upon the absence of certain specific daily records, but may

be ascertained by means of any evidence upon which a taxpayer's taxable income can be determined, including net worth and disbursements evidence and the testimony of witnesses. Therefore, to say that the basic question is whether Exhibit 3 is an accurate record of Showell's bookmaking activities is to confine the issue too narrowly, unless, as petitioners have suggested several times in this case, the Commissioner asserted additional income against petitioners as punishment for not maintaining records satisfactory to him. One thing is certain. The issue before this Court is not limited to the question of whether Exhibit 3 is an accurate record of Showell's bookmaking activities. The basic question before this Court is whether or not petitioners have carried their burden of proof as it is defined by case law, whether or not there is any substantial evidence in support of the Tax Court's findings of fact, and whether or not the Tax Court has incorrectly applied the applicable law.

At page 13, respondent pleads that the Tax Court was forced to deal with evidence that it did not consider satisfactory and therefore should not be criticized for reaching a result which it believes is correct on the record before it. However, this lack of additional evidence was a deed of the Tax Court's own choosing since it refused to admit the net worth and disbursements methods evidence although at the same time it was finding as fact that the petitioners' books and records were inadequate. Furthermore, if a trial court is to be sustained simply because it believes what it did was correct on the record before it, there would be no point in any litigant appealing to this Court. The question is whether or not, in the opinion of this Court, The Tax Court acted correctly under the applicable rules of evidence, procedure and substantive law.

Petitioners point out again that the briefs filed by respondent in this case are unresponsive to the arguments contained in petitioners' opening brief. The fair inference to be drawn from such

failure to respond is that the arguments contained in petitioners' opening brief were not susceptible of an answer.

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February 6, 1958

Respectfully submitted,
W. Lee McLane, Jr.
Nola McLane
Counsel for Petitioners

McLane & McLane
Of Counsel